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In the Supreme Court of the United States

OCTOBER TERM, 1958.

No. 585

NICHOLAS FERRAIOLO,
Petitioner,

v.

F. R. NEWMAN,
Respondent.

PETITION FOR WRIT OF CERTIORARI.

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To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner Nicholas Ferraiolo prays that a writ of certiorari issue to the United States Court of Appeals for the Sixth Circuit to review the judgment of that Court in Cause No. 13,345, wherein that Court affirmed a judgment entered by the United States District Court for the Northern District of Ohio granting the Respondent's motion for summary judgment.

OPINIONS BELOW.

The Opinion of the District Court, Judge Paul Jones, granting the motion of the Defendant-Respondent for summary judgment has not been reported. It is printed in the Joint Appendix filed in the Court of Appeals at pages 40a to 43a. Nine extra copies of the Joint Appendix have been filed with this Petition.

The Order of the District Court appears in the Joint Appendix filed in the Court of Appeals at pages 43a and 44a.

The Opinion of the Court of Appeals, Judge Potter Stewart (Chief Judge Charles C. Simons, and Judge Shackleford Miller, Jr. concurring), is in the Appendix to this Petition, page 22, and is reported at 259 F. 2d 342.

The Judgment of the Court of Appeals is in the Appendix to this Petition at page 28.

JURISDICTION.

The judgment presented for review is dated and was entered September 24, 1958.

There was no order respecting re-hearing below nor granting an extension of time within which to petition for a writ of certiorari in this Court.

Jurisdiction of this Court is invoked under 28 U. S. C. Section 1254(1), upon petition for certiorari filed within the ninety days prescribed by 28 U. S. C. Section 2101(c). These sections are as follows:

Section 1254:

"Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree;"

Section 2101(c):

"Any other appeal or any writ of certiorari intended to bring any judgment or decree in a civil action, suit or proceeding before the Supreme Court

for review shall be taken or applied for within ninety days after the entry of such judgment or decree. A justice of the Supreme Court, for good cause shown, may extend the time for applying for a writ of certiorari for a period not exceeding sixty days."

THE QUESTION PRESENTED FOR REVIEW.

—The Law.

Sections 16(a) and 16(b) of the Securities Exchange Act of 1934 were enacted to prevent the unfair use of information that may have been obtained by corporate officers, directors, or major stockholders. They provide that if such an insider realizes any profit from the purchase and sale or sale and purchase of any equity security issued by his corporation and if the purchase and sale are within any period of less than six months, then the profit shall inure to and be recoverable by the corporation.

—The Facts.

The Respondent, a director of the Ashland Oil and Refining Company, acquired a block of its common stock by conversion of preferred. Less than six months later, after a substantial rise in the price of the common, he sold some of it.

The corporation, Petitioner intervening, sued to recover Respondent's profit.

The conversion ratio of the preferred was protected against dilution and the relative market prices of the two stocks approximately reflected this ratio. Shortly before Respondent converted his preferred it was called for redemption at a price below its market value, so that if he had permitted the preferred to be redeemed Respondent would have suffered a substantial loss.

—Respondent's Choice.

But this loss could be avoided either by conversion of the preferred into common or by outright sale of the preferred. Respondent chose to convert.

It is possible that this choice was guided by an insider's knowledge that the price of the common was likely to go up.

—The Question.

In the terms and circumstances of this case is the acquisition of common stock by conversion of preferred a "purchase" within the meaning and intent of Sections 3(a)(13) and 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. Sections 78c(a)(13) and 78p(b)?

The Court below answered "No."

Petitioner believes the answer should be "Yes."

THE STATUTE INVOLVED.

This case arises under Sections 16(a) and 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. Sections 78p(a) and 78p(b). These sections are as follows:

> "(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security or within ten days after he becomes such beneficial owner, director, or officer, a statement with the exchange (and a duplicate original thereof with the Commission) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, shall file with the exchange a statement (and

a duplicate original thereof with the Commission) indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter, but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

Section 3(a)(13) of the Securities Exchange Act of 1934, 15 U. S. C., Section 78(a)(13) defines the term "purchase" as follows:

"The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire."

STATEMENT OF THE CASE.

—The Parties.

Petitioner Ferraiolo is a stockholder and Respondent Newman was a Director of Ashland Oil and Refining Company. Joint Appendix pp. 3a, 6a, 11a.

—The Two Classes of Stock.

Ashland had two classes of stock, common and preferred, both listed on the New York Stock Exchange, a national securities exchange. Joint Appendix pp. 3a, 6a, 10a. The preferred stock was cumulative, callable, and convertible into common. Joint Appendix p. 23a. Originally the conversion ratio was 1:1, but the Articles of Incorporation by which it was created provided that the ratio would be adjusted to compensate for any change in the amount of common outstanding by way of a stock dividend or stock split. A 10 percent stock dividend on the common in May, 1951, raised the ratio so one share of preferred would get 1.1 shares of common. Joint Appendix p. 8a.

The convertibility of the preferred was reflected in its market price, for when the price of the common climbed above the redemption price of the preferred the price of the preferred followed that of the common. Joint Appendix pp. 19a, 21a.

—The Call For Redemption.

On November 15, 1951, the Company issued a call for redemption of the preferred stock on December 17, 1951. Joint Appendix p. 23a. Of the 228,358 shares of the preferred stock that were outstanding on the date the call was issued Respondent F. R. Newman held 43,720. Joint Appendix p. 7a. The redemption price, 27¼ per share, was approximately nine dollars a share less than the cur-

rent market price of the preferred or of the 1.1 shares of common for which it could be exchanged. Joint Appendix pp. 21a, 23a. Thus to hold the preferred until it was redeemed would yield Newman nine dollars a share less than if he were to sell it for cash before the redemption date, or convert it into common.

—Respondent's Election.

On November 23, 1951, Newman exercised his right to exchange the preferred for common, and for his 43,720 shares of Ashland preferred he received 48,092 shares of Ashland common, which then had a market price of about 33⅛. Joint Appendix pp. 6a, 21a. Between December 17, 1951, and January 22, 1952, he sold 20,000 shares of the common at prices ranging from 35⅞ to 42¼. Joint Appendix pp. 25a, 27a.

—This Action.

On demand of the Petitioner the Company sued in the United States District Court for the Northern District of Ohio to recover Respondent's profit, pursuant to Section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. Section 78p(b). Petitioner intervened, and all three parties moved for summary judgment.

The principal issue before the Court was whether Newman's conversion of Ashland's preferred stock into common stock constituted a "purchase" of the common within the intent and meaning of Sections 3(a)(13) and 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. A. Sections 78c(a)(13) and 78p(b).

The District Court, Paul Jones, Chief Judge, found for the defendant, Respondent Newman. Petitioner Ferraiolo appealed to the United States Court of Appeals for the Sixth Circuit, which affirmed.

—Rationale Below.

The rationale of the Court below was that Newman's election to convert his shares of Ashland preferred stock into common was "involuntary," since "he would have lost approximately nine dollars a share if he had allowed his preferred shares to be redeemed." While he could have sold his preferred, "it can hardly be said that a failure to sell is tantamount to a purchase," the Court said.

REASONS FOR GRANTING THE WRIT.

A. The decision of the United States Court of Appeals for the Sixth Circuit, review of which is sought hereby, is in direct conflict with the decision by the United States Court of Appeals for the Second Circuit in the case of *Park & Tilford, Inc. v. Schulte*, 160 F. 2d 984, cert. denied, 332 U. S. 1016 (1947). In the *Park & Tilford* case, the conversion of preferred shares into common stock was held to constitute a "purchase" of common stock within the intent and purpose of Section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. Section 78p(b). The decision by the United States Court of Appeals for the Sixth Circuit involving the instant case, *Ferraiolo v. Newman*, [illegible] 2d 342, has held that the conversion of preferred shares into common stock is not a "purchase" of the common within the meaning and intent of Section 16(b) of the Act, *supra*.

That this conflict between the Second Circuit and the Sixth Circuit cannot be explained away by distinguishing the two cases is shown by the reasoning of two other cases in the Second Circuit, *Blau v. Mission Corporation*, 212 F. 2d 77, Cert. denied, 347 U. S. 1016, and *Roberts v. Eaton*, 212 F. 2d 82, cert. denied, 348 U. S. 827 (1954).

B. The Court of Appeals for the Sixth Circuit has decided an important question of Federal law which has not

been, but should be, settled by this Court and has decided it in a way that conflicts with the applicable decisions by the Court of Appeals for the Second Circuit. These conflicting decisions involve important questions of national scope which are of the greatest importance and concern to the investing public of the United States as well as to the management of all corporations listed upon any national securities exchange. The decision by the Court of Appeals for the Sixth Circuit finds no sanction in the Securities Exchange Act of 1934 and is in conflict with the stated Congressional purpose and intent.

ARGUMENT.

A. CONFLICTS WITH DECISIONS OF OTHER COURTS OF APPEALS.

1. PARK & TILFORD CASE.

The decision in point is *Park & Tilford, Inc. v. Schulte*, 160 F. 2d 984 (1947), decided by the United States Court of Appeals for the Second Circuit. In this case Judge Clark stated the rule that Petitioner believes should govern this case as follows:

> "We think a conversion of preferred into common stock followed by a sale within six months is a 'purchase and sale' within the statutory language of Section 16(b). Whatever doubt might otherwise exist as to whether a conversion is a 'purchase' is dispelled by definition of 'purchase' to include 'any contract to buy, purchase, or otherwise acquire.' Section 3(a)(13). Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock, within the meaning of the Act. The Act certainly applies as well to executed acquisitions as to executory contracts to acquire. Not otherwise could the Act accomplish the Congressional purpose

to protect the outside stockholders against at least short-swing speculation by insiders with advance information. Smolowe v. Delendo Corporation, supra, 2 Cir., 136 F. 2d 231, 235, 148 A. L. R. 300; Kogan v. Schulte, D. C. S. D. N. Y., 61 F. Supp. 604."

a. Attempted Distinction.

The Court of Appeals sought to distinguish the *Park & Tilford* case on three grounds:

(1) Newman's conversion of preferred stock into common was in a very real sense involuntary.

(2) The preferred stock in the *Park & Tilford* case was "nonmarketable" and the "marketable common stock * * * was 'more valuable.'"

(3) The convertibility of the preferred shares in the *Park & Tilford* case was not protected against dilution.

(1) Involuntary Conversion.

(a) THREE CHOICES.

In the *Park & Tilford* case it was claimed that the conversion was involuntary and this defense was met by Judge Clark with the following language:

"The transaction may not, as defendants assert, be withdrawn from operation of the Act on the theory that the conversion was a forced, and not a voluntary, act by defendants. Whatever might be the considerations involved in that situation, it is clear that here defendants were not forced to convert, but instead made an everyday business decision as to the most profitable of three courses of action—redemption, conversion, or outright sale of their preferred. Indeed, the contention that defendants were forced to convert is somewhat absurd, in view of the fact that since defendants controlled plaintiff they could have prevented the passage of the redemption resolu-

tion or rescinded it after it had been passed." (160 F. 2d pp. 987, 988.)

While it is true in this case that Respondent Newman did not hold majority control of Ashland and presumably did not have it within his power to prevent or rescind the call for redemption of his preferred, the remainder of Judge Clark's answer is fully applicable here. Newman had the same three choices that the Schultes had in the *Park & Tilford* case.

(b) KEY STATEMENT IS A DECEPTIVE OVERSIMPLIFICATION.

The opinion of the Court of Appeals acknowledges that Newman could have sold the preferred shares on the open market instead of converting them but counters this acknowledgment with the key statement:

"* * * it can hardly be said that a failure to sell is tantamount to a purchase."

This statement of the Court of Appeals is a deceptive oversimplification.

[1] Complaint Is Against Purchase and Re-sale.

In the first place, Petitioner's complaint is not against a failure to sell but against a decision by Newman to sell his preferred stock for common—thus purchasing the common—rather than to sell the preferred for cash, combined with a profitable re-sale of the common thus acquired within less than six (6) months thereafter.

[2] Key Statement Begs the Question.

In the second place, if the above-quoted statement of the Court of Appeals is re-phrased to state the real issue it appears to be completely circular, stating nothing but the conclusion to be reached. Consider the following paraphrase:

"It can hardly be said that a decision to convert the preferred stock into common rather than sell it for cash is tantamount to a purchase of the common."

(2) Common More Valuable.

The distinction drawn by the Court of Appeals on the ground that the Schultes "exchanged nonmarketable preferred shares for marketable common stock which was 'more valuable'" ignores the fact that in this case too Newman acquired common stock that was really more valuable than the preferred with which he bought it. Surely the fact that the preferred stock was about to be redeemed at a price $9.00 lower than the market value of the common that he could get for it demonstrates that the common was "more valuable" than the preferred.

(a) ONLY PARTIALLY EQUIVALENT.

We may acknowledge that Newman's preferred and common were economic equivalents in *some* sense, that is that the preferred could be exchanged for common and that it was protected against dilution of the conversion privilege by stock splits or stock dividends applied to the common. But this is by no means a complete equivalence, for the preferred and common stock had separate bundles of rights that could not be enjoyed simultaneously. The preferred had guaranteed and cumulative though limited dividends and preference on dissolution. On the other hand, it was subject to having these rights extinguished by redemption and the preferred shareholder's only protection was but a partial one: to convert his preferred stock into common shorn of the preferences. Moreover, once the call for redemption was issued the preferred stock immediately became a far less desirable stock to hold. The holder of preferred had to convert to common or sell the preferred for cash in order to avoid its redemption at a considerable drop in price.

(3) Protection Against Dilution.

Protection against dilution is insufficient.

That *only a complete and mathematical equivalence will provide immunity* is the lesson to be drawn from two other cases, *Blau v. Mission Corporation*, 212 F. 2d 77, and *Roberts v. Eaton*, 119 F. Supp. 362, 212 F. 2d 82. These cases too were decided by the Second Circuit.

2. BLAU v. MISSION CORPORATION.

a. The Facts of the Case.

Blau v. Mission Corporation, supra, involved transactions in the stock of Tide Water Associated Oil Company. Mission Corporation owned a large block of Tide Water stock, and in December, 1948, conveyed it to a newly organized wholly-owned subsidiary, Mission Development Corporation, in exchange for the stock of the subsidiary. Shortly afterwards Mission Corporation distributed part of the stock in the subsidiary to its own shareholders. Thereafter Mission Development stock was listed on the New York Stock Exchange and was freely traded there. Meanwhile Mission continued to buy Tide Water stock and in January, 1951, conveyed a second block of it to Mission Development, the subsidiary, on the same terms as before.

Plaintiff sued on the theory that each of these exchanges with Mission Development constituted a sale of the Tide Water stock, with which plaintiff sought to match purchases of Tide Water stock that had been made within six months before or after each sale, claiming liability for profits under Section 16(b).

b. Mathematically Exact Equivalence—Immunity.

The Court held that the first exchange of Tide Water stock for that of Mission Development, the subsidiary, was not a sale since Mission Development was a wholly-

owned subsidiary and Mission Corporation did not divest itself of real ownership of the Tide Water stock by this exchange.

In other words, what it held after the exchange was the equivalent of what it held before—with mathematical exactness.

c. No Longer Equivalent—Liability.

The second exchange with Mission Development, however, did constitute a sale, the Court held, because by that time Mission Corporation was no longer the sole stockholder of Mission Development. By the stock dividends, the public listing, and the market sales of Mission Development stock, Mission Development had achieved independent value before the second exchange. Although the defendant's commitment in Tide Water stock was not immediately reduced by the exchange the Court observed that the ownership had been one step removed and the intervening Mission Development stock was independently valued.

d. The Test: Possibility of Use of Inside Information.

The Court said:

> "It is not beyond conceit that an insider would possess information which when publicly released would depress Tide Water prices while enhancing those of Development. Moreover, if Mission were to receive stock in an exchange such as this, and thereafter sell it within six months, we have no doubt that the exchange would be a 'purchase' within Section 16(b)."

Thus, although there was a direct relationship between the value of the Tide Water stock and the value of the stock of Mission Development, the subsidiary, the intrinsic value of Mission Development being absolutely

tied to the underlying Tide Water, the economic equivalence was not so mathematically exact at the time of the second exchange as to immunize it from the application of the statute.

The situation left leeway enough to make it possible for an insider to be guided by and to profit from inside information. Therefore the insider was held liable.

3. ROBERTS v. EATON.

a. The Facts of the Case.

In *Roberts v. Eaton, supra,* the defendants were the former controlling stockholders of Old Town Corporation, principally Eaton and his family, who held 45.9 percent of the corporation's stock. Desiring to sell out and retire, Eaton found that he could sell the stock more readily and at better prices if the corporation's one class of common stock was re-classified into common and preferred, to be sold separately. The directors proposed such a re-classification and informed the stockholders fully of the reasons for it and a special meeting of the stockholders gave their approval by a more than two thirds vote. A month after the re-classification, the defendants sold the stock. To the plaintiff's contention that the receipt by Eaton of the preferred and common stock on re-classification was a purchase, the District Court replied that such a re-classification was not a purchase since the equivalence was mathematically exact: each stockholder held afterwards *exactly* what he had held before. On appeal the District Court's judgment was affirmed.

b. Factors That Make for Liability.

Judge Clark's opinion reviewed the cases in which liability had been established and concluded that where acquisitions of stock were held to be purchases within the Act, there were three common characteristics:

(1) There was an individual option of the insider to acquire the security or not as he saw fit;

(2) The securities acquired were part of a pre-existing class, substantial portions of which were publicly held, and which had an independent value in a pre-existing market;

(3) The securities received were either those of a different corporation from the one whose securities were given in exchange (*Blau v. Mission Corporation*, 212 F. 2d 77; second half of *Blau v. Hodgkinson*, 100 F. Supp. 361), or the insider's acquisition resulted in his holding a different proportional interest in the securities of the issuer (*Park & Tilford, Inc. v. Schulte*, 160 F. 2d 984; and the first half of *Blau v. Hodgkinson*, 100 F. Supp. 361).

Judge Clark found that these elements were not present in *Roberts v. Eaton, supra.*

c. Factors That Make for Immunity.

He observed that the fact that the defendants' control of the corporation made the conversion a voluntary one on their part lost some of its force when the re-classification and proposed subsequent sale were disclosed and time-consuming ratification by the stockholders was required. He remarked also that like treatment of all stockholders would in most cases remove the possibility of abuse. He agreed with the District Court that after the re-classification the defendants had held the same interests and rights as before until they sold their stock. He observed that the intrinsic value of a new issue relates directly to the underlying property; any variance depends

on market preferences of which an insider would have no more knowledge than the rest of the world.

Judge Clark concluded with the warning that the fact that after the re-classification the defendants had held the same interest as before would not be sufficient to immunize the transaction from the liabilities of Section 16(b) if it stood alone and perhaps that none of the factors he mentioned would do so, but in cumulative effect they did.

d. Factors that Make for Liability Here.

Returning to Judge Clark's analysis of the factors that make for liability, we find they are all present here.

(1) There was an individual option of the insider to acquire the security or not as he saw fit: as we have shown, Newman could have elected to sell his preferred stock for cash instead of for common.

(2) The common stock acquired here by conversion of the preferred was part of a pre-existing class, publicly held, having an independent value in a pre-existing market; it was not a new issue of whose value an insider would have no more knowledge than the rest of the world.

(3) Newman's acquisition of the common did result in his holding a different proportional interest in the securities of Ashland. Obviously, after the conversion he held a larger proportion of common and a smaller proportion of preferred. This is the only sense in which there was a change in proportional interest in the *Park & Tilford* case. We have already observed the differences between the preferred and common with respect to dividends and liquidation rights.

e. Factors Claimed to Make for Immunity Here.

The Sixth Circuit apparently sought to bring this case within Judge Clark's factors that make for immunity, for it asserted:

> "all of the preferred shareholders were treated alike; full disclosure was made to them, the conversion worked no material change in the proportional equity ownership of Ashland."

(1) The Sixth Circuit Missed the Point.

We come here to one of the points at which the Sixth Circuit seems to have failed most seriously to grasp the true significance of the facts of the case. Only a few lines before the above statement its opinion referred to the fact that the holders of more than 99 percent of the outstanding preferred shares chose to convert them to common. This is probably much of the source of what Petitioner believes to be the error of the Court below, for the proportion of preferred stock that finally got converted rather than redeemed is utterly immaterial. The proportion would be large even if all of those who held preferred stock on November 15, 1951, when the call was issued, sold their stock for cash. Those who bought it would proceed to convert rather than allow redemption.

(2) The Point Is the Possibility of Use of Inside Information.

Remembering that the purpose of the statute is to protect the public, that is, outsider stockholders, against unfair use of information available only to insiders we must ask whether there is a possibility that Newman used inside information in deciding to convert his preferred rather than sell it for cash. Obviously, since he was an insider and since, in fact, the market price of the common stock ..at he bought with his preferred did rise rapidly in

the next two months, his transaction here could well have been guided by inside information. It is here that we must apply the test as to whether all stockholders were treated alike. The Court of Appeals said that they were and that full disclosure was made to them. *But of course there is no evidence that outsiders were given any inside information that the common was likely to go up after Newman converted his preferred to common.*

(3) Who Was Hurt?

Who are the outsiders that were hurt by this transaction? The answer is, those who sold their preferred stock in ignorance that the common was going up; those who lost an opportunity to buy the preferred that Newman might have put on the market if he had not converted his preferred to common; and, since we must look at the whole transaction, those who later bought common from Newman in anticipation of further price increases and found instead a general though slight decline setting in shortly after Newman completed his sales.

(4) Objective Standard of Proof.

We do not claim to have any knowledge or evidence that Newman did in fact have inside information of the character we have supposed for the purpose of this analysis, but proof of such actual knowledge is not required by the statute. The statute establishes an objective standard of proof. *Smolowe v. Delendo Corporation*, 136 F. 2d 231 (1943); *Gratz v. Claughton*, 197 F. 2d 46 (1951); *Walet v. Jefferson Lake Sulphur Company*, 202 F. 2d 433 (1953). The Court of Appeals admitted as much when it asserted that Newman's inactivity as a director was entirely irrelevant, citing the *Smolowe* and *Gratz* cases; and, as the Court of Appeals said, counsel for Newman readily conceded it.

(5) The Correct Rule.

What must govern the decision here is the *possibility* that Newman was guided by inside information when he chose to convert rather than to sell his preferred stock or when he subsequently sold his common less than six months later.

It is a curious fact that the Court of Appeals drew the correct rule out of the cases but failed to apply it to the facts of this case. The Court of Appeals' opinion states:

> "The standard that emerges from these decisions can be simply stated: Every transaction which can reasonably be defined as a purchase will be so defined, if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16(b). Accepting that standard, we turn to the relevant circumstances of the present case."

(6) Incorrect Application of the Rule.

Having enunciated this excellent statement of the rule and its intention to turn to the relevant circumstances of the present case the Court of Appeals omitted all reference to the controllingly relevant circumstance that Newman's decision to convert rather than sell could have been guided by inside knowledge. This circumstance makes the transaction one of a kind that *can* possibly lend itself to the speculation encompassed by Section 16(b) and thus the transaction should be defined a purchase.

4. CONCLUSION.

Since it failed to understand this circumstance the decision of the Court of Appeals for the Sixth Circuit is in clear conflict with those of the Second Circuit in *Park & Tilford, Inc. v. Schulte, Blau v. Mission Corporation*, and *Roberts v. Eaton*.

The petition for certiorari should be granted.

B. AN IMPORTANT QUESTION OF FEDERAL LAW THAT SHOULD BE SETTLED BY THIS COURT.

So far as counsel for Petitioner has been able to find there has been no decision of this Court on the scope and sweep of Section 16(b) of the Securities Exchange Act of 1934. Most of the decisions on this Section have come from the Second Circuit and this Court has repeatedly denied certiorari. We do not question the wisdom of the Court's practice as to these past cases for they have enunciated a consistent and vigorous policy of full enforcement of the intent of the statute. But in this case a conflict has developed between the Sixth Circuit and the Second that should be resolved. For if the present case is allowed to stand it would create the appearance of a loophole that seems likely to encourage much insider speculation and to produce considerable litigation before it can be either closed or firmly opened.

The petition for certiorari should be granted.

Respectfully submitted,

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APPENDIX.

OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

(Filed September 24, 1958.)

Before SIMONS, Chief Judge, MILLER and STEWART, Circuit Judges.

STEWART, Circuit Judge. This appeal involves the applicability of Section 16 (b) of the Securities Exchange Act of 1934, 15 U. S. C. A., § 78p (b). That section provides that any profit realized by a corporate director resulting from his purchase and sale of the corporation's stock within less than six months shall inure to the corporation.[1]

In 1948 the appellee, Newman, acquired 43,720 shares of the convertible preferred stock of Ashland Oil and Refining Co. (Ashland) as a result of a merger. At that time Newman became a director of Ashland. More than three years later, on November 23, 1951, he exercised the right to convert these shares into 48,092 shares of Ashland com-

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[1] If the corporation is the issuer of equity securities listed on a national securities exchange. Section 16 (a) and (b) provide.

"(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security or within ten days after he becomes such beneficial owner, director, or officer, a statement with the exchange (and a duplicate original thereof with the Commission) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, shall file with the exchange a statement (and a duplicate original thereof with the Commission) indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

(Continued on following page)

mon stock. Within six months thereafter, he sold 20,000 shares of Ashland common stock at prices in excess of the November 23, 1951, price.

Upon demand of the appellant Ferraiolo, a stockholder, Ashland brought this action against Newman to recover Newman's profits resulting from the above transaction. Ferraiolo was permitted to intervene. The district court entered a summary judgment in favor of Newman, holding that the transaction was not covered by Section 16 (b) of the Act. Only the intervenor has appealed.

It can fairly be gathered from the abbreviated record that Newman was a very inactive director of Ashland, and that during the period in question he was not in fact privy to any inside information concerning the company. Such considerations, however, are entirely irrelevant to the applicability of Section 16 (b), as counsel for Newman

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(Continued from preceding page)

"(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection." 15 U. S. C. A., § 78p (a) and (b).

readily concede. *Smolowé v. Delendo Corp.*, 136 F. 2d 231, 235-36 (2 Cir., 1943), cert. den. 320 U. S. 751; *Gratz v. Claughton*, 187 F. 2d 46, 49-50 (2 Cir., 1951), cert. den. 341 U. S. 920.

It is evident that the narrow question in this case is whether Newman's acquisition of the Ashland common stock upon conversion of his preferred stock on November 23, 1951, was a "purchase" within the meaning of Section 16 (b) of the Act. If so, Newman was liable to the corporation for the profit he realized when he sold 20,000 shares of the common stock within the ensuing six months. *Smolowe v. Delendo Corp., supra*, at 237-39; *Gratz v. Claughton, supra*, at 50-52.

The statute itself furnishes no definition that would supply an easy answer to the question. It provides only that the term "purchase" *includes* "any contract to buy, purchase, or otherwise acquire." 15 U. S. C. A., § 78(c)(13). It is thus apparent that while the transaction here was not one falling within the ordinary concept of a "purchase,"[2] nevertheless the statutory definition would not necessarily exclude it.

It is also apparent, however, that the question is not in any event primarily a semantic one, but must be resolved in the light of the legislative purpose—to curb short swing speculation by insiders. Most of the litigation involving the meaning to be given "purchase" in Section 16 (b) has arisen in the District Court for the Southern District of New York. A series of decisions in that court and in the Court of Appeals for the Second Circuit have marked out an approach to the problem which is pragmatic rather than technical. Each case has been decided on its

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[2] "The generally understood meaning of 'purchase' is to acquire something by one's own act or agreement for a price." *Shaw v. Dreyfus*, 172 F. 2d 140, at 142 (2 Cir., 1949), cert. den. 337 U. S. 907.

own facts, and the enunciation of a "black letter rubric" has been expressly avoided. *Park & Tilford, Inc. v. Schulte*, 160 F. 2d 984, cert. den. 332 U. S. 761 (1947); *Shaw v. Dreyfus*, 79 F. Supp. 533, 172 F. 2d 140, cert. den. 337 U. S. 907 (1949); *Truncale v. Blumberg*, 80 F. Supp. 387 (1948); *Blau v. Hodgkinson*, 100 F. Supp. 361 (1951); *Blau v. Ogsbury*, 210 F. 2d 426 (1954); *Blau v. Mission Corporation*, 113 F. Supp. 153, 212 F. 2d 77, cert. den. 347 U. S. 1016 (1954); *Roberts v. Eaton*, 212 F. 2d 82, cert. den. 348 U. S. 827 (1954).

The standard that emerges from these decisions can be simply stated: Every transaction which can reasonably be defined as a purchase will be so defined, if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16 (b). Accepting that standard, we turn to the relevant circumstances of the present case.

The preferred shares which Newman acquired in 1948 were convertible by the owners at any time prior to July 15, 1958, into Ashland common shares on a share-for-share basis. However, the convertibility of the shares was protected against dilution by a provision that the conversion

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This is substantially the same test as that proposed in "The Scope of 'Purchase and Sale' under Section 16 (b) of the Exchange Act," 59 Yale L. J., at 513 (1950):

"Some transactions, however, are neither clearly included in, nor excluded from, the statutory definition of 'purchase' and 'sale.' As used in Section 16 (b), 'purchase' may or may not include the receipt, by virtue of stock ownership of stock rights and stock dividends. 'Sale' may or may not include gifts, whether for charitable or non-charitable purposes. The exercise of a conversion feature may or may not be either or both. If insider trading is to be effectively deterred, 'purchase' and 'sale' must consequently be interpreted in the light of Section 16 (b)'s purpose. The question whether to include particular transactions within their scope therefore must be tested by the following standard—is inclusion necessary to recover profits made from short term insider speculation?"

ratio should be adjusted in the event of any change in the number of outstanding common shares, so that, in 1951 when Ashland declared a ten per cent stock dividend on its common shares, the conversion ratio became 1 preferred for 1.10 common, and additional common shares were reserved and set aside to correspond with the changed rate. Both Ashland preferred and Ashland common were registered securities and listed on the New York Stock Exchange. The preferred shares were fully redeemable by Ashland at a fixed price upon thirty days written notice but during the thirty-day period the conversion privilege remained unimpaired.

On November 15, 1951, Ashland called all of the then outstanding convertible preferred shares for redemption at $27 a share on December 17, 1951. During almost all of the preceding year Ashland common had been selling on the New York Stock Exchange at prices in excess of this redemption price. By reason of their undilutable conversion privilege, Ashland preferred shares had been selling at a price equivalent to the common, when adjusted to reflect the 1.10 conversion ratio. At the time the preferred shares were called for redemption, the market price of Ashland preferred and Ashland common (adjusted) was approximately $36 per share, or $9 per share more than the redemption price. Faced with a choice of permitting his preferred shares to be redeemed at $27 a share or converting them into common shares selling for $36, Newman naturally took the latter course, as did the holders of more than 99 per cent of the outstanding preferred shares.

The convertible preferred shares which Newman acquired in 1948 were subject at any future time to call for redemption. Once the market price of the common stock rose above the redemption price of the preferred, the preferred, with its undilutable conversion privilege, became

in the objective judgment of the market place, the economic equivalent of the common. The real effect of Ashland's subsequent call of the preferred for redemption was simply to force the surrender of the preference features of the preferred. All of the preferred shareholders were treated alike; full disclosure was made to them; the conversion worked no material change in the proportional equity ownership of Ashland.

This, then, is a case quite different from *Park & Tilford, Inc., v. Schulte*, 160 F. 2d 984 (2 Cir., 1947), cert. den. 332 U. S. 761, upon which the appellant heavily relies. In that case the insiders exchanged nonmarketable preferred shares for marketable common stock which was "more valuable." See *Blau v. Mission Corporation*, 212 F. 2d 77, at 81 (2 Cir., 1954), cert. den. 347 U. S. 1016. The convertibility of the preferred shares in that case was not protected against dilution. The two classes of shares were not, therefore, in any sense economic equivalents. Moreover, the conversion in that case was voluntary in that the insiders had complete control of the corporation and could, therefore, determine whether the preferred would be called for redemption. See *Roberts v. Eaton*, 212 F. 2d 82, at 83 (2 Cir., 1954), cert. den. 348 U. S. 827.

Here, by contrast, Newman's conversion of preferred stock into common was in a very real sense involuntary. He would have lost approximately nine dollars a share if he had allowed his preferred shares to be redeemed. While it is true that he could have sold the preferred shares on the open market instead of converting them, it can hardly be said that a failure to sell is tantamount to a purchase.

In short, an analysis of the circumstances of this case leads to the conclusion that the district court was not in error in holding Newman free from Section 16 (b) liability. Newman's conversion of Ashland preferred to Ash-

land common had none of the economic indicia of a purchase; it created no opportunity for profit which had not existed since 1948. The transaction was not one that could have lent itself to the practices which Section 16.(b) was enacted to prevent.

The judgment of the district court is affirmed.

JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

(Filed September 24, 1958.)

Appeal from the United States District Court for the Northern District of Ohio.

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Ohio, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby affirmed.



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In the Supreme Court of the United States

OCTOBER TERM, 1958.

No. 585.

NICHOLAS FERRAIOLO,
Petitioner,

v.

F. R. NEWMAN,
Respondent.

BRIEF OF RESPONDENT.

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F. R. NEWMAN,

Respondent.

BRIEF OF RESPONDENT.

OPINIONS BELOW.

The opinion of the Court of Appeals for the Sixth Circuit (App. to Pet. for Cert., p. 22) is reported in 259 F. 2d 342. The opinion of the District Court for the Northern District of Ohio (Joint App., p. 40a), which was affirmed on appeal, is reported in 163 F. Supp. 506.

STATUTE INVOLVED.

The pertinent provisions of the Securities Exchange Act of 1934 are set forth in the Appendix, *infra*, page 15. Section 16(b) of that Act, 15 U. S. C. § 78p(b), provides, in so far as here pertinent, that any profit realized by a director from any "purchase and sale" of exchange-listed stock of his corporation "within any period of less than six months * * * shall inure to and be recoverable by the issuer * * *." There is no definition of "purchase" in the Act except that provided by § 3(a)(13), 15 U. S. C. § 78(a)(13): "The terms 'buy' and 'purchase' each *include* any contract to buy, purchase, or otherwise acquire." (Italics supplied.)

QUESTION PRESENTED.

Was the conversion of a convertible preferred stock into common stock a "purchase" within § 16(b) when (1) an increase in the market price of the common above the redemption price of the preferred had caused the market price of both preferred and common (when adjusted to reflect the conversion ratio) to be the same for more than ten months preceding the conversion, and (2) more than 99% of all the outstanding preferred was converted in order to avoid its being redeemed at some $9 per share below its market price?

STATEMENT.

1. The Statutory Scheme.

Section 16 of the Securities Exchange Act of 1934 was the answer of Congress to the abuses with respect to "insider trading" which had been exposed by the Senate investigation.[1] Section 16(a) requires every director or officer of a company having an equity security registered on an exchange, as well as every beneficial owner of more than ten percent of any equity security so registered, to file monthly reports with respect to any change in his holdings of any equity security of the same issuer. Section 16(b) provides for the automatic recapture, by the issuer or by any security holder suing on the issuer's behalf, of any profit realized by any such director, officer or ten percent owner from "in-and-out trading" in any equity security of his company within a period of less than six months. The test in § 16(b), in marked contrast to that in § 16(a), is "purchase and sale" rather than "any change in such [beneficial] ownership."

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[1] For a general discussion of § 16(b), see Loss, Securities Regulation (1951 with 1955 Supp.) 561-98.

Section 16(b) was described by the Administration's principal spokesman for the 1934 bill as a "crude rule of thumb."[2] If the period which elapses between a director's "purchase" and "sale" is six months less a day, he is liable without regard to any showing of either the existence or an actual abuse of inside information. Conversely, a director who holds for six months or more is not liable under § 16(b), no matter how much proof is adduced of unfair resort to inside information.

Everything turns, therefore, on whether there is a "purchase" followed by a "sale" within a period of less than six months. It is entirely beside the point to inquire whether there was "inside information," whether it was used or abused, or whether it might have been so used. In the ordinary, classic case of cash purchases and cash sales there is nothing to litigate. Obviously the case at bar is not a classic purchase. It is an extremely rare situation and arises solely because Respondent, a director, sold common stock on the market within less than six months after he, as well as all other holders of convertible preferred stock, had been *forced* to convert to common because the issuer had called the preferred for redemption at a time when both preferred and common were selling on the market at $9 above the redemption price of the preferred.

2. Facts.

The facts—which are not in dispute—are simple enough:

Convertible preferred (hereafter referred to as preferred) and common shares of Ashland Oil and Refining

[2] 15 Stock Exchange Practices, Hearings before Senate Committee on Banking and Currency, 73d Cong., 2d Sess. (1934) 6557.

Company were acquired by Respondent in 1948 in the course of a merger into Ashland of another company in which Respondent had been one of the principal shareholders. The preferred, which was created at that time, was listed on the New York Stock Exchange, where the common had already been listed. Since the conversion privilege of the preferred was fully protected against dilution, the declaration, in May 1951, of a ten percent stock dividend on the common entitled each share of preferred to 1.1 shares of common on conversion.

The redemption price of the preferred was $27 per share. By January 5, 1951, the market price of the common had climbed above $27. When this phenomenon occurs, it is axiomatic in the world of finance that the preferred (after adjustment for the conversion ratio) becomes the economic equivalent of common. The market price of the preferred will not rise above the market price of the common because of the lower redemption price. Nor will the market price of the preferred ever fall below that of the common, because it can always be converted into common even though it is called for redemption. In other words, the process of arbitrage will keep the market price of the two securities "locked together" until the company sees fit to force conversion of the preferred by calling it for redemption.

Precisely that happened in this case. Desiring to be rid of the preferred stock so that it would be free to raise additional capital through the issuance of a new series of convertible preferred, the company called the preferred for redemption on December 17, 1951, at which time the adjusted market price of the common was some $9 higher than the redemption price of the preferred. The holders of more than 99% of the preferred, including Respondent, converted, and within the next few months Respondent

sold common stock on the market at prices higher than the "locked together" market price of both preferred and common on the date of conversion. (Joint App., pp. 19a-21a.)

ARGUMENT.

1. There Is No Conflict With the Opinion of the Second Circuit in the Only Other Conversion Case.

Park & Tilford, Inc. v. Schulte, 160 F. 2d 984 (2d Cir.), cert. denied, 332 U. S. 761, the only other conversion case under § 16(b), was correctly distinguished by the court below in a number of vital respects:

(a) Here, Respondent's conversion was genuinely "forced." The real effect of the call for redemption was simply to force the surrender of the preference features of the preferred (App. to Pet. for Cert., p. 27). In *Park & Tilford*, by contrast, the defendants' control of the company was so pervasive that—as Judge Clark himself pointed out in *Roberts v. Eaton*, 212 F. 2d 82, 85 (2d Cir.), cert. denied, 345 U. S. 827, in distinguishing his earlier opinion in *Park & Tilford*—Schulte could "work his will through the board of directors." Hence, in *Park & Tilford* the court concluded that "the contention that defendants were forced to convert is somewhat absurd * * *." 160 F. 2d at 988.

(b) In *Park & Tilford* "the insiders exchanged non-marketable preferred shares for marketable common stock which was 'more valuable' " (App. to Pet. for Cert., p. 27). Here, in contrast, "Once the market price of the common stock rose above the redemption price of the preferred, the preferred, with its undilutable conversion privilege, became, in the objective judgment of the market place,

the economic equivalent of the common. * * * the conversion worked no material change in the proportional equity ownership of Ashland." (App. to Pet. for Cert., pp. 26-27.)

(c) The convertibility of the Park & Tilford preferred was not protected against dilution. Here, it was fully protected. Indeed, it seems fair to say that preferred stock which is not so protected is not a genuinely convertible preferred, and that it would probably violate the fraud provisions of the securities statutes to represent such a stock as "convertible" without a clear indication that the conversion privilege was not protected.

Judge Stewart (as he then was) might have gone further and observed that, in *Park & Tilford*, the call and conversion had all been part of a scheme of the Schultes to profit by converting the closely held preferred, which could not be sold to the public because it had no market and would have had to be registered under the Securities Act of 1933, into common which was already listed on a stock exchange and had an established market, and then unloading the readily marketable common on a public which had been led to run up the price of the common through a Schulte-inspired rumor that the board of directors would declare a dividend payable in whiskey.[1]

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[1] On December 15, 1943, Schulte had publicly announced that Park & Tilford was contemplating a distribution of whiskey to its shareholders at cost. (One must remember the whiskey shortage at that time.) The stock advanced from 57⅜ on that day to a high of 98¼ on May 26. On May 26 the company offered to sell to its stockholders at a reduced price six cases of whiskey for each share of stock. On May 31 the Office of Price Administration limited the negotiability of the purchase rights and the maximum profits on the resale of the liquor. The price of the stock dropped 10⅛ points that day and reached a low of 23⅝ in August. On December 20, 1943, the company served notice of redemption of its preferred stock; on January 19, 1944, the defendants, who owned some 91% of the outstanding stock

To be sure, Judge Clark did state in *Park & Tilford*: "We think a conversion of preferred into common stock followed by a sale within six months is a 'purchase and sale' within the statutory language of § 16(b)." 160 F. 2d at 987. But he was addressing himself to the facts of the particular case then before the court, which was only the second appellate decision anywhere under § 16(b) and the first to involve the meaning of "purchase" or "sale." Even so, Judge Clark was careful to ground his rejection of the Schultes' "forced conversion" theory on the fact that they were in complete control of the company. Putting to one side and reserving for future consideration the case of a genuinely forced conversion, he said: "Whatever might be the considerations involved in that situation, it is clear that here the defendants were not forced to convert * * *." 160 F. 2d at 987-88.

Since *Park & Tilford*, the courts have had to deal with the applicability of § 16(b) to the issuance of stock purchase rights or warrants, which they have held may or may not involve a "purchase",[1] to an exchange of securities with a subsidiary, which may or may not involve a "sale" of the securities transferred to the subsidiary depending upon whether the subsidiary is wholly owned at

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(Continued):

converted their preferred into common; and from December 15, 1943, to June 1, 1944, they sold approximately 93,000 shares of common. These facts are related in the Weeks affidavit, ¶ 17 *et seq.* and Ex. G. That portion of the Weeks affidavit was based largely on the Commission's opinion in *Ira Haupt & Co.*, 23 SEC 589 which was referred to by Judge Clark in the *Park & Tilford* case (160 F. 2d at 990-91) as showing "the nature of the evidence which a trial would bring forth."

[1] *Shaw v. Dreyfus*, 172 F. 2d 140 (2d Cir.), cert. denied, 337 U. S. 907 (not a "purchase" when issued to a director on the same basis as other stockholders); *Truncale v. Blumberg*, 80 F. Supp. 387 (S. D. N. Y.) (issuance of incentive warrants to an officer pursuant to an employment contract *is* a "purchase").

the time; and to a corporate merger, which may involve a "purchase" although the same result does not necessarily follow in the case of a stock reclassification. In each case the decision turned upon the facts of the particular situation before the court.

By 1954, when the Second Circuit held that a reclassification of common into a new preferred and new common did not involve a "purchase" of the new preferred, Judge Clark stated that the court was "not inclined at this juncture to attempt enunciation of a black-letter rubric." 212 F. 2d at 85. That is to say, it is impossible in the light of the statutory purpose to declare that *all* mergers or *all* reclassifications—or *all* conversions—either do or do not come within § 16(b). Instead, the common thread running through all these cases, including the opinion below, is whether, in Judge Stewart's words, the circumstances were such as to create an "opportunity for profit" which had not existed before, so that it might "reasonably be defined as a purchase," or whether the transaction was "one that could have lent itself to the practices which Section 16(b) was enacted to prevent" (App. to Pet. for Cert., pp. 25, 28).

Mr. Justice Harlan has recently seen fit to remind the Bar that "differences between the Courts of Appeals in two or more circuits will not be accepted as a conflict if they can fairly be accounted for on the basis of variations in the factual situations among the cases involved." Harlan, *Manning the Dikes—Some Comments on the Statutory Certiorari Jurisdiction and Jurisdictional State-*

Blau v. Mission Corp., 212 F. 2d 77 (2d Cir.), cert. denied, 347 U. S. 1016.

Blau v. Hodgkinson, 100 F. Supp. 361 (S. D. N. Y.).

Roberts v. Eaton, 212 F. 2d 82 (2d Cir.), cert. denied, 348 U. S. 827.

ment Practice of the Supreme Court of the United States, 13 Record of Assn. of Bar of City of N. Y. 541, 552 (1958). The only resemblance between *Park & Tilford* and the case at bar is that both involve conversions. Respondent has always accepted *Park & Tilford* as correctly decided. It was carefully distinguished below. There is no conflict

2. The Case Was Correctly Decided Below.

First: Since it manifestly will not do to say that *all* conversions, mergers, reclassifications, issues of stock purchase rights, and the like either do or do not involve "purchases," the courts have developed a test in terms of the statutory purpose. Cf. *SEC v. Ralston Purina Co.*, 346 U. S. 119, 124-25: "The natural way to interpret the private offering exemption [in the Securities Act of 1933] is in light of the statutory purpose: Since exempt transactions are those as to which 'there is no practical need for [the bill's] application,' the applicability of § 4(1) should turn on whether the particular class of persons affected needs the protection of the Act." So, in interpreting § 16 the courts generally (including both the lower courts in this case) have carefully distinguished, in the various situations not involving a classic purchase or sale, between those which in statutory context have the same economic attributes and consequences as a purchase or sale and those which do not. They pay no attention to whether the director did in fact have or use inside information, which is irrelevant, but consider whether the circumstances of the particular case were such that, assuming the possession or use of inside information, he could have obtained an advantage over the public generally which did not already exist. Thus, in *Roberts v. Eaton*, 212 F. 2d 82, 86, cert. denied, 348 U. S. 827, the Second Circuit concluded:

"The reclassification at bar [a reclassification of common stock into common and preferred by a class vote of stockholders so that a better price could be obtained on sale of the preferred to institutional investors who would not be interested in buying common] could not possibly lend itself to the speculation encompassed by § 16(b)." Again, in *Shaw v. Dreyfus*, 172 F. 2d 140, 142 (2d Cir.), cert. denied, 337 U. S. 907: "'Inside' information which the directors may have cannot possibly be used to the detriment of other stockholders in voting to grant rights to all stockholders of record in proportion to their existing holdings; all are treated equally." And in *Falco v. Donner Foundation, Inc.*, 208 F. 2d 600, 604 (2d Cir.): "Indeed, arbitrage is so clearly divorced from the abuses which § 16(b) seeks to prevent that an implied exception could be urged with some force even absent the express provisions of § 16(d) [exempting arbitrage]." In short, *cessante ratione cessat ipsa lex*.

Second: There was no conceivable opportunity for Respondent to use inside information in determining whether to convert in order to avoid a loss of $9 per share on the call for redemption. No person, unless he were out of the country or unable to act, would have permitted redemption. If the company had called the preferred when the common had been selling *below* the redemption price, the normal economic compulsion would have been for public stockholders to let their shares be redeemed and a director with inside knowledge of favorable future developments might have elected to convert. But that is not the situation here, as shown by the fact that more than 99% of the preferred stockholders acted as Respondent did. As Judge Clark stated for the Second Circuit in *Roberts v. Eaton*, 212 F. 2d at 85: "Nor can it

be gainsaid that like treatment of all stockholders will in most cases remove the possibility of abuse."

Third: It is true, of course, that Respondent may have had the benefit of inside information in determining when to sell his common stock after the conversion. But, apart from the fact that the market in the common continued to go up after his sales, this possibility is irrelevant and question-begging. For, if there had been no conversion and Respondent had sold the preferred shares which he had held for several years, there would have been no cause of action under § 16(b) regardless of how much inside information he might have had.

Moreover, it is no answer to say that a director in Respondent's position could always sell the preferred instead of converting. Suppose he had happened to buy preferred stock in the market at a lower price for investment purposes within the preceding six months. He would have to turn the profit over to the company even though he had been powerless to prevent the call for redemption which had forced on him the Hobson's choice of converting or selling.

Again, if a conversion is a "purchase" of common, presumably it is also a "sale" of preferred, which under Petitioner's view would have to be matched against any market purchase of preferred within six months before or after the conversion. No director could ever buy preferred or sell common without the risk that a forced conversion within the next six months would subject him to severe liability. Surely this was not the purpose of Congress when it attacked the problem of "in-and-out trading."

Fourth: Under the circumstances of this case, the conversion was no more significant than an exchange of a certificate for 200 shares of common into two certificates

of 100 shares each. To quote once more from a § 16(b) opinion of Judge Clark, on whom Petitioner relies so heavily, "for all practical purposes a convertible bond is equivalent to the number of shares of stock into which it is convertible." *Falco v. Donner Foundation, Inc.*, 208 F. 2d 600, 603, n. 2 (2d Cir.). Both the purpose and the effect of the anti-dilution provisions here were to preserve to every preferred shareholder his inviolable right to share in the growth of the company on a proportionate basis fixed at the time when the preferred stock was created, and to assure every preferred shareholder that the preferred could never have a value *less* than the value of the common into which it was convertible. The important factor in the context of § 16(b) is equivalence from the standpoint of opportunity to profit through trading, not from the standpoint of preferences in dividends or liquidation. For trading purposes, the preferences lost all value once the market price of the common had risen above the redemption price of the preferred. In economic reality, Respondent sold only that (less the preferences) which he had owned since 1948. To put it differently, the *only* reason that the preferred had a higher market value than its redemption price was the privilege of conversion; no one would have paid Respondent $36 for the right to get $27 on redemption.

Fifth: Since the statute does not define the term "purchase," it has its ordinary meaning in the field to which the legislature was addressing itself—in this case, the field of securities and investment banking—at least when this meaning does not produce a result inconsistent with the general statutory purpose. Petitioner introduced no evidence to counter the affidavits of three investment bankers (Joint App. 29a, 33a, 38a) to the effect that conversion of a fully protected, convertible preferred into

common stock under the circumstances of this case is not regarded as a purchase of common in "the investment, financial and business world."

Sixth: Petitioner's construction would result in recovery under § 16(b) when the use of inside information could not possibly have created a new opportunity for profit, but would raise a serious question as to the applicability of § 16(b) to a *market* purchase of *preferred* followed by a *market* sale of *common* (or vice versa) within a period of less than six months—a classic situation for potential abuse of inside information. Respondent's construction, on the other hand, by treating a fully protected convertible preferred and the common as economic equivalents, would facilitate the application of § 16(b) to such a situation, in which it is most needed.

Moreover, since Petitioner concedes that Respondent would not have been liable if he had responded to the call by selling the preferred which he had held for several years instead of converting it into its economic equivalent and then selling common a few months later, Petitioner's construction would exalt form over substance notwithstanding Judge Clark's admonition in *Blau v. Mission Corp.*, 212 F. 2d 77, 80 (2d Cir.), cert. denied, 347 U. S. 1016, that "undue stress" must not be put on formality so as to reach "harsh and wooden results quite unnecessary to achieve the purposes of the act."

3. There Is No Question of Federal Law Sufficiently Important to Warrant Supreme Court Review.

First: The most significant statement in the Petition for Certiorari will be found on page 20, where Petitioner concedes that "the Court of Appeals drew the correct rule out of the cases but failed to apply it to the facts

of this case." To quote once more from Mr. Justice Harlan's Cardozo Lecture (*supra* at 553), the case is not one for the Supreme Court even if the issue is "a 'just' result to [the] client under what may well be a 'better view' of the law." *A fortiori* this Court does not sit as a second reviewing court when all that is involved is the question whether the first reviewing court failed to apply a concededly correct rule of law to the facts of the particular case. It is also not without significance that all four judges who sat on this case reached the same result.

Second: This is only the second conversion case in the twenty-five years which have elapsed since § 16(b) has been on the books. Particularly since Petitioner concedes that the court below drew the correct general rule out of the cases, the applicability of that rule to conversions effected under varying fact circumstances is not a sufficiently recurring question to warrant Supreme Court review.

CONCLUSION.

The decision below is correct. It is conceded by Petitioner that the court below correctly determined the law. There is neither conflict nor need for further review. Accordingly, the petition for a writ of certiorari should be denied.

Respectfully submitted.

LOUIS LOSS,
JAMES A. WEEKS,
Counsel for Respondent.

February, 1959.

APPENDIX.

Securities Exchange Act of 1934, § 3(a)(13), 15 U. S. C. § 78c(a)(13):

(13) The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire.

Securities Exchange Act of 1934, § 16, 15 U. S. C. § 78p:

(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security or within ten days after he becomes such beneficial owner, director, or officer, a statement with the exchange (and a duplicate original thereof with the Commission) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, shall file with the exchange a statement (and a duplicate original thereof with the Commission) indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable

by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

* * *

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No. 585

In the Supreme Court of the United States

OCTOBER TERM, 1958

NICHOLAS FERRAIOLO, PETITIONER

v.

F. R. NEWMAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

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OPINIONS BELOW

The opinion of the Court of Appeals is reported at 259 F. 2d 342 (Pet. 22–28). The opinion of the District Court (R. 40–43) has not been reported.

JURISDICTION

The judgment of the Court of Appeals was entered on September 24, 1958 (Pet. 28). The petition for a writ of certiorari was filed on December 17, 1958. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, within the meaning of Section 16(b) of the Securities Exchange Act of 1934, providing that insiders' profits from the purchase and sale of a class

of equity securities within a six-months period are recoverable on behalf of the corporation, a "purchase" of common stock does not necessarily include any acquisition thereof by an insider through conversion of his holdings of preferred stock.

STATUTE INVOLVED

Section 16(b) of the Securities Exchange Act of 1934, 48 Stat. 896 (1934), 15 U.S.C. 78p(b), and Section 3(a)(13) of that Act, 48 Stat. 884 (1934), 15 U.S.C. 78c(a)(13) are set forth at page 5 of the petition.

STATEMENT

Pursuant to Section 16(b) of the Securities Exchange Act of 1934, the petitioner, a stockholder in Ashland Oil and Refining Company ("Ashland"), seeks to recover, on behalf of Ashland, profits of the respondent, a director of Ashland, realized through the acquisition and sale of Ashland's common stock within a six-months period. The common stock of Ashland is listed on the New York Stock Exchange, a national securities exchange (Pet. 26), as was also the preferred stock prior to its redemption. Respondent had acquired 48,092 shares of Ashland's common stock on November 23, 1951, through the conversion of 43,720 shares of Ashland's preferred stock (Pet. 22). On that date, the common stock of Ashland was selling on the New York Stock Exchange at about 33⅛ and the preferred stock was selling at approximately 36¼ (R. 21). The complaint alleges that respondent sold 20,000 shares of Ashland common stock from December 19, 1951 through Jan-

uary 24, 1952, at prices ranging from 36 to 44⅞ (R. 4–5).

In 1948, the respondent had acquired his preferred stock of Ashland and had become a director of that corporation (Pet. 22). The conversion option in the preferred stock contained an anti-dilution provision, and at the time of conversion the ratio was 1.1 shares of common stock for each share of preferred (Pet. 26). During most of the year prior to the conversion, the market price of common stock into which the preferred was convertible (*i.e.*, the market price of 1.1 shares of common) was above the redemption price of the preferred stock (Pet. 26–27). Respondent's conversion followed a notice by Ashland on November 15, 1951, that the preferred shares would be redeemed on December 17, 1951, at the redemption price of $27 a share (Pet. 26).

On demand of petitioner, Ashland instituted this action in the United States District Court for the Northern District of Ohio, and the petitioner intervened. The District Court granted a motion by the respondent for summary judgment (R. 43–44). The petitioner appealed and the Court of Appeals for the Sixth Circuit affirmed (Pet. 28).

ARGUMENT

1. The Securities Exchange Act of 1934 is specifically designed, *inter alia*, "to insure the maintenance of fair and honest markets" in securities transactions (Section 2 of the Act, 15 U.S.C. 78b). Section 16(b) of the Act seeks to implement this general purpose by making it unprofitable for insiders to engage in short-swing speculation. The preamble to the sec-

tion states that it was enacted "[f]or the purpose of preventing the unfair use of information which may have been obtained by * * * [a ten percent stockholder], director, or officer by reason of his relationship to the issuer * * *."

The abuses which led to the enactment of Section 16(b) are discussed in the legislative history of the Act.[1] Among these abuses were transactions in which insiders, with advance knowledge of facts which would produce a rise in the market price of the stock of their company, bought stock at then current market prices and sold it when publication of the information had caused the anticipated rise to occur. There were also transactions in which insiders with advance knowledge of facts which would depress the market price sold their stock at then current prices and repurchased when publication had the anticipated effect. On occasion, the ability to obtain such profits led insiders to manipulate the market price of their stock by causing their corporation to follow financial policies calculated to produce sudden changes in market prices.[2] To prevent such practices in an effective manner, and in view of the difficulty of proving intent

[1] See S. Rep. No. 1455, 73d Cong., 2d Sess. (1934), pp. 55–68; S. Rep. No. 792, 73d Cong., 2d Sess. (1934), pp. 7–9; H. Rep. No. 1383, 73d Cong., 2d Sess. (1934), pp. 13–14.

[2] In its discussion of the proposed Section 16(b), S. Rep. No. 792, 73d Cong., 2d Sess. (1934), states at p. 9:

"* * * Such a provision will render difficult or impossible the kind of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information * * *. In a particularly glaring instance, the chairman of the executive commit-

on the part of insiders to speculate on inside information, Congress in Section 16(b) adopted a "rule of thumb"[3] whereby profits from "any purchase and sale or any sale and purchase" of a class of equity securities within a six-months period are recoverable on behalf of the corporation. "Purchase" is elsewhere defined in the Act to include "any contract to buy, purchase or otherwise acquire",[4] and "sale" is defined to include "any contract to sell or otherwise dispose of."[5] The Securities and Exchange Commission is specifically authorized to exempt by rule transactions "not comprehended within the purpose of this subsection."

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tee and another director participated in a pool organized in [*sic*] trade in the stock of their company when the stock was paying no dividends. During the operation of the pool, which continued for a period of 2 years, they caused the company to resume the payment of dividends, more than 25 per cent of which were received by the pool participants. These dividends were paid * * * in spite of the fact that the company's earnings were not sufficient to meet them * * *".

[3] The operation of Section 16(b) was explained by Thomas G. Corcoran, one of its draftsmen, during the hearings which led to its adoption, as follows: "That is to prevent directors receiving the benefits of short-term speculative swings on the securities of their own companies, because of inside information. The profit on such transaction under the bill would go to the corporation. You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation; and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing." *Hearings on Stock Exchange Practices*, Senate Committee on Banking and Currency, 73d Cong., 1st Sess., pt. 15 (1934), at p. 6557.

[4] Section 3(a)(13), 15 U.S.C. 78c(a)(13).

[5] Section 3(a)(14), 15 U.S.C. 78c(14).

2. In line with the broadly remedial purpose of Section 16(b), the courts have construed it liberally in a manner calculated "to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty."[6] Thus, they have applied the statutory definitions of purchase or sale to such transactions as the exercise of stock options granted in consideration of the insider's services,[7] the exchange of stock in a subsidiary for stock of its parent pursuant to a plan of corporate simplification,[8] and the exchange by an insider corporation of stock of its company for stock of its less-than-wholly-owned subsidiary.[9] Consistently, in *Park & Tilford* v. *Schulte,* 160 F. 2d 984, certiorari denied, 332 U.S. 761, the Court of Appeals for the Second Circuit held, in 1947, that the conversion of preferred stock into common stock constituted a purchase of the common stock.

3. We believe that the decision below, holding that here the conversion of preferred stock into common stock was not a purchase of the common stock within the meaning of Section 16(b), is in conflict with *Park & Tilford* and is inconsistent in principle with the

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[6] *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231, 239 (C.A. 2), certiorari denied, 320 U.S. 751.

[7] *Walet* v. *Jefferson Lake Sulphur Co.*, 202 F. 2d 433 (C.A. 5), certiorari denied, 346 U.S. 820; *Blau* v. *Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y.); *Truncale* v. *Blumberg*, 80 F. Supp. 387 (S.D.N.Y.).

[8] *Blau* v. *Hodgkinson*, 100 F. Supp., *supra*, fn. 7.

[9] *Blau* v. *Mission Corp.*, 212 F. 2d 77 (C.A. 2), certiorari denied, 347 U.S. 1016.

other cases referred to above. In our view, the essence of the *Park & Tilford* decision is that any acquisition of a security pursuant to a contract right is, by definition, a purchase.[10]

While the court below found distinctions between *Park & Tilford* and the instant case, we submit that the facts upon which reliance was placed should not be considered relevant to the determination of liability under Section 16(b). One distinction suggested is that the conversion in this case was involuntary, in the sense that the call for the redemption of the preferred stock at a lower price necessitated its conversion to prevent loss. There was also a call for redemption in *Park & Tilford*. The court there pointed out (160 F. 2d at 988) that the "defendants [merely] made an everyday business decision as to the most profitable of three courses of action—redemption, conversion, or outright sale of the preferred."[11] The respondent

[10] See 160 F. 2d, *supra*, at 987:

"We think a conversion of preferred into common stock followed by a sale within six months is a 'purchase and sale' within the statutory language of § 16(b). Whatever doubt might otherwise exist as to whether a conversion is a 'purchase' is dispelled by definition of 'purchase' to include 'any contract to buy, purchase, or otherwise acquire.' § 3(a)(13). Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock, within the meaning of the Act. The Act certainly applies as well to executed acquisitions as to executory contracts to acquire. Not otherwise could the Act accomplish the Congressional purpose to protect the outside stockholders against at least short-swing speculation by insiders with advance information. * * *"

[11] See also *Blau* v. *Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y.), holding that an exchange by corporate insiders of stock of a subsidiary for stock of its parent, pursuant to a plan of cor-

here made a similar choice; he elected to convert, rather than to sell his preferred at the then market price or permit its redemption.

The Sixth Circuit below also noted that the insiders in *Park & Tilford* had complete control of the corporation and therefore held the power to determine whether the preferred could be called for redemption. Here there was no showing that the respondent was in control. But the design of Section 16(b) is to eliminate the necessity of proof of control or of the receipt of inside information. As noted by Judge Learned Hand in *Gratz* v. *Claughton,* 187 F. 2d 46, 50 (C.A. 2), certiorari denied, 341 U.S. 920:

> * * * If only those persons were liable, who could be proved to have a bargaining advantage, the execution of the statute would be so encumbered so as to defeat its whole purpose. * * *

The other distinction relied upon below is that the preferred shares in *Park & Tilford* were not the economic equivalent of the common shares into which they were converted, since they were "not protected against dilution" (although there is nothing in the *Park & Tilford* decision so indicating [12]) and were unmarketable, and hence of less value (Pet. 27). But this unmarketability was not referred to in the original *Park & Tilford* opinion; it was mentioned for the

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porate simplification, was not involuntary, since the insiders could have exercised their right as dissenters to demand the cash value of the stock of the subsidiary.

[12] It appears that the absence of such a provision in the Park & Tilford preferred stock was brought to light by an affidavit filed in the District Court in this case (R. 37–38).

first time in connection with the denial of a requested rehearing with respect to the question of damages. 160 F. 2d at 990. In the original decision of the Second Circuit, moreover, it was specifically assumed that the defendant might have effected an "outright sale of the preferred" (see *supra*, p. 7).[13]

In any event, we submit that the preferred shares in this case were likewise not the economic equivalent of the common stock into which they were ultimately converted. They represented interests in Ashland senior to those represented by the common stock and thus provided their holders with a degree of protection against the risks inherent in common stock. Thus, the conversion involved an exchange of essentially different securities. Cf. *Roberts* v. *Eaton*, 212 F. 2d 82 (C.A. 2), certiorari denied, 348 U.S. 827.[14]

While it might well be that the existence of the conversion privilege tends to increase the market value of the preferred stock in proportion to in-

[13] The stock was unmarketable only in the sense that it was not traded on an exchange or otherwise actively traded; and that any public offering would have required registration under the Securities Act of 1933, 48 stat. 74, as amended, 15 U.S.C. 77a, *et seq.* (160 F. 2d at 990). In the original opinion the Court of Appeals assumed that the market value of the preferred was $364,871, the amount found by the District Court and conceded by the parties. *Id.* at 988.

[14] In the *Roberts* case, it was held that receipt of common stock was not a purchase within the meaning of section 16(b) of the Act where it resulted from a reclassification whereby all stockholders received for each share of $5 par value common a package consisting of one share of $1 par value common and one share of $7 par value 40 cents cumulative preferred. The court there noted that the fact that the insiders' position remained proportionately unchanged was "of course an essential for defendants' position". 212 F. 2d at 86.

creases in the market value of the common stock, thus enabling the insider to attain profits without the necessity for conversion, this feature should not immunize short-swing transactions by insiders who do actually convert. The possibility of redemption, inherent in most issues of preferred stock, tends to limit the extent of profits that might be made without conversion, since a prudent corporate management will often redeem where the market price of the preferred goes substantially above its redemption price.[15] Moreover, having had the advantages of a preferred stock—which might include a redemption price in excess of the conversion value in bad times—the preferred stockholder who converts should not be able to claim that, for the purposes of Section 16(b), he is to be treated as having been the owner of the common stock from the start.

Any sale or purchase, whether within six months or not, might be based on inside information. As we have noted, the design of Section 16(b) is by a prophylactic rule to take the profit out of short-term speculation by insiders in the securities of their company, and thus reduce possible instances of misuse of inside information. We see no reason to assume that Congress did not intend the broad definition of purchase and sale in the Act to include the exchange of one class of security for another within the six-

[15] It should be noted that the respondent here could not have obtained the profits involved in this case without conversion, since the rise in the market value of the common stock occurred for the most part after the redemption date (R. 19–21).

months "rule of thumb."[16] Until the decision below, the courts had uniformly interpreted the Act broadly and liberally to support this "rule of thumb." And the Act contains within itself strong indication that the courts are to apply the rule generally, leaving it to the Commission to make appropriate exemptions for transactions which fall within the letter of Section 16(b) but not its spirit. For the last sentence of the section (Pet. 5) expressly authorizes the Commission to exempt, by rules and regulation, any transaction which it deems "not comprehended within the purpose of this subsection."[17]. The transactions involved here have not been so exempted.

4. The importance of Section 16(b) as a means for protecting corporate security holders against incidents of misuse of inside information, described in the legislative history as "most vicious practices,"[18] cannot be indicated by the relatively small number of cases which have been brought under that provision. The very simplicity of the remedy afforded against short-swing transactions—coupled with the requirements of

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[16] Congress evinced specific concern with respect to the grant of options, whereby "manipulative operations" could "be conducted with a minimum of financial risk to the manipulators." H. Rep. No. 1383, 73d Cong., 2d Sess, pp. 10, 11. Like the exercise of other options, exercise of the conversion privilege is susceptible to abuse by insiders who, in the absence of Section 16(b), could hold senior securities with a minimum of financial risk, and at the opportune time capitalize upon the common stock by conversion and sale at a quick profit.

[17] The Commission has adopted such rules. See 17 C.F.R. 240.16b–1, *et seq.*

[18] S. Rep. No. 1455, *supra*, fn. 1, at p. 55.

Section 16(a) for disclosure of all transactions by all officers, directors and 10 percent stockholders—is a powerful deterrent to short-swing speculation by insiders. Since it casts uncertainty on the right of action by the corporation or its stockholders, the determination on a case-by-case basis, as suggested below, of whether or not an exchange of securities is a purchase would tend to reduce the use of the statutory cause of action, and thereby decrease Section 16(b)'s deterrent effect. In addition, any conflict between the circuits in this type of case is especially to be deplored, as corporations subject to Section 16(b) are listed on national securities exchanges and are generally engaged in interstate businesses, a factor which enables suit to be brought in any one of a number of jurisdictions.

CONCLUSION

For the foregoing reasons, we believe that the petition for a writ of certiorari should be granted.

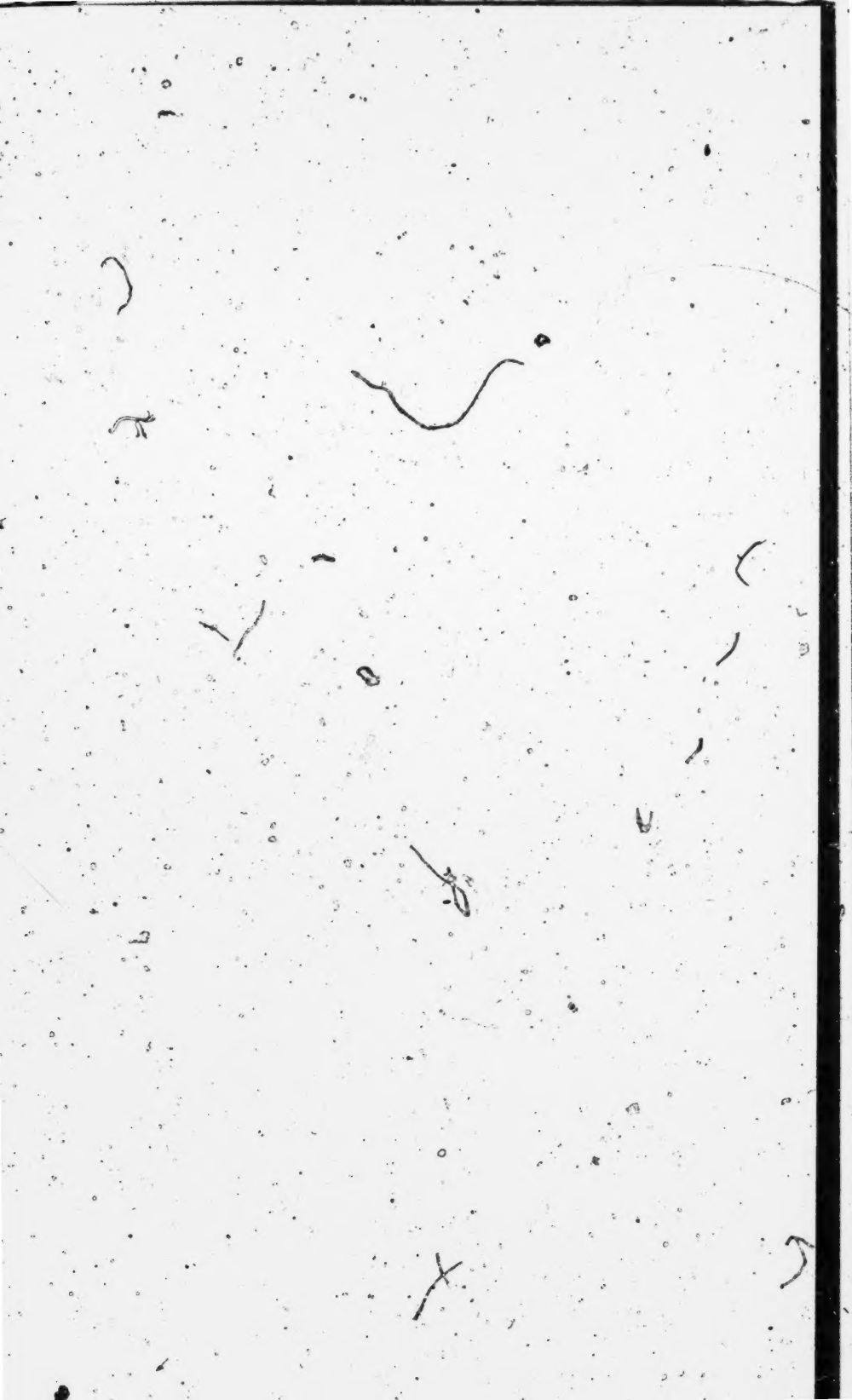
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In the Supreme Court of the United States

OCTOBER TERM, 1958

No. 585

NICHOLAS FERRAIOLO,
Petitioner,

v.

F. R. NEWMAN,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF OF RESPONDENT IN REPLY TO BRIEF FOR SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

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We respectfully suggest that the Commission's brief was not filed on time and should be disregarded. Although Paragraph 4 of the Court's Rule 42 exempts the Government from the requirement of consent to the filing of a brief as *amicus curiae*, the Government is not exempted—and there is no logical reason why it should be—from the provision in Paragraph 1 that an *amicus* brief may be filed "only if submitted a reasonable time prior to the consideration * * * of the petition for writ of certiorari." The petition was filed on December 17, 1958, and at Respondent's request Petitioner consented to a thirty-day extension of the time for filing Respondent's brief, which accordingly

became due on February 16, 1959. The Commission's brief was filed on that very day—the day when the clerk is directed by Paragraph 3 of Rule 24 to distribute the papers to the Court for its consideration—which is hardly "a reasonable time prior to the consideration * * * of the petition."

The Commission not only had sixty days after the filing of the petition, it had five months after the decision of the Court of Appeals, to decide whether it agreed or disagreed with the decision. Indeed, the Respondent himself submitted a complete statement of the case to the Commission several years ago, many months before the case was decided even by the District Court. Notwithstanding all this, the Commission comes in on the very last day on which Respondent's own brief is due, making no excuses for its lateness and not desiring, apparently, to risk denial of a motion for extension of time.

The Commission's late filing is an imposition upon Respondent because the necessity of his filing two briefs has added to his printing costs as well as the work of his counsel. In this sense the harm has been done, because Respondent now has no choice as a practical matter but to answer the Commission's brief. Nevertheless, rejection of the Commission's brief would be a salutary demonstration of the reciprocal nature of the maxim that the citizen must cut square corners in his dealings with the Government.

If the Court does accept the Commission's brief, we respectfully request that it consider the following comments on it:

First: The Commission has chosen not to adjust the market prices quoted in its statement of the case so as to reflect application of the effective conversion ratio. The real relation of the prices of the preferred and common on the date of conversion was not 33⅛ to 36¼, as stated at

page 2 of the Commission's brief, but 33.01 to 33.18 (Joint App., p. 21a), the latter difference being the result of normal arbitrage. The Court could, of course, arrive at the correct figures by making the necessary computation from the conversion ratio stated on page 3 of the Commission's brief. But this is not the standard of disclosure which the Commission itself applies under the Securities Act of 1933. There it very properly insists that the prospectus may not be arranged "in such fashion as to obscure any of the required information or any information necessary to keep the required information from being incomplete or misleading." 17 Code Fed. Regs. §230.421(a).[1] Here the shoe is on the other foot. The Commission, especially when it enters a case as a friend of the court rather than a prosecutor, should be scrupulously careful to bring out all the relevant facts and all the relevant law. It has done neither here, and this is a further reason why its brief should be disregarded or heavily discounted.

Second: When we say that the Commission has not brought to the Court's attention all the relevant law, we have in mind particularly the sentence at the top of page 11 of its brief: "Until the decision below, the courts had uniformly interpreted the Act broadly and liberally to support this 'rule of thumb.'" This sentence, in context, creates a seriously misleading impression. The Commission has carefully culled every one of the unorthodox cases (those not involving ordinary trading) in which the courts concluded that there *was* a "purchase" or "sale" within the meaning of §16(b). But it either ignores or studiously obscures the fact that the Second Circuit (where most of these cases have arisen) has decided for the defendant

[1] It seems fair to observe that the Commission has actually issued stop orders "where the failure to limit or qualify an inexact statement at the very point where it was made was held to render the prospectus deficient, notwithstanding the statement was susceptible of correction from information supplied elsewhere in the prospectus." *Income Estates of America*, 2 SEC 434, 442, and cases cited.

about as often as it has for the plaintiff. See pages 7-8 of Respondent's earlier brief. Thus:

(a) The Commission in its note 7 carefully collects all the cases holding that the exercise of stock options does involve a "purchase." But it fails anywhere to cite *Shaw* v. *Dreyfus*, 172 F. 2d 140 (2d Cir.), cert. denied, 337 U. S. 907, where it was held that the issuance of stock to a director pursuant to stock purchase rights or warrants on the same basis as other stockholders was *not* a "purchase."

(b) The Commission at page 6 of its brief correctly cites *Blau* v. *Mission Corp.*, 212 F. 2d 77 (2d Cir.), cert. denied, 347 U. S. 1016, for the proposition that "the exchange by an insider corporation of stock of its company for stock of its less-than-wholly-owned subsidiary" does involve a "purchase." But the Commission—incredibly—fails to point out that the very same case held that a similar exchange effected when the subsidiary was still wholly owned did *not* involve a "purchase."

(c) The Commission's only comment on the Second Circuit's latest decision—*Roberts* v. *Eaton*, 212 F. 2d 82, cert. denied, 348 U. S. 827, the most important opinion of all because Judge Clark there produced a painstaking synthesis of all the prior cases—is consigned to a cryptic, and itself misleading, footnote (SEC Br., p. 9, n. 14).[2] Is there any conceivable reason for this belittling except that the court there concluded that a reclassification of common stock into preferred and common did *not* involve a "purchase"?

Third: The Commission is forced into this strange process of selectivity in order to support its thesis, long since exploded by the Second Circuit if it ever existed, that "*any* acquisition of a security pursuant to a contract right is, by

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[2]To answer one footnote with another, we must confess our mystification at the Commission's sole attempt to distinguish *Roberts* by referring to the court's emphasis of the fact that the insiders' position remained proportionately unchanged. There was likewise no proportionate change in Respondent's position in the case at bar when he merely converted his preferred stock into common.

definition, a purchase" (SEC Br., p. 7, with italics supplied). We could understand an argument—though we would be bound to disagree with it—that §16(b) *should* be so construed. But what the Commission is trying to persuade the Court is that it *has* been so construed—that the decision below is in conflict not only with *Park & Tilford* but also "in principle" (SEC Br., p. 6) with the Second Circuit's opinions in the other cases cited in its brief. The one principle which runs through these cases was made explicit in the latest of them, *Roberts* v. *Eaton*, in which the Second Circuit, after a thorough reappraisal of all the earlier cases, expressed its disinclination "at this juncture to attempt enunciation of a black-letter rubric." 212 F. 2d at 85. What the Commission would now have this Court do is precisely that—something which both the Second Circuit and the Sixth Circuit have refused to be enticed into doing. And in its search for the never-never land of legislative automation which has eluded every code drafter in history, the Commission ignores the many good reasons (enumerated in our earlier brief at pages 10-13) why a black-letter rubric here might well frustrate rather than further the very purpose of the provision in question.

Fourth: We agree, of course, that in most cases §16(b) operates automatically as the "crude rule of thumb" it was designed to be. We ourselves pointed this out at page 3 of our earlier brief. But surely it does not follow that a transaction not exempted by Commission rule under the last sentence of §16(b) is automatically covered. The bootstrap quality of this argument (SEC Br., p. 11)—which Petitioner himself abandoned in the Court of Appeals after making it in the District Court—needs no demonstration. There was no exemptive rule in *Roberts*, or in *Shaw*, or in *Blau* v. *Mission Corp.*

Fifth: The Commission states that options could be abused for manipulative purposes (SEC Br., p. 11, n. 16). We agree. *Park & Tilford* was such a case. The present case is not. It is no answer to point out that the *Park &*

Tilford opinion did not expressly take into account the unmarketability of the stock[3] or the absence of any protection against dilution. Courts decide cases as they arise, and take into account those facts which are essential to the decision of the particular controversy. *Park & Tilford* was a chapter in a crude market manipulation. If the present case had arisen first instead of *Park & Tilford*, the court might just as understandably have said (Resp. Br., p. 7): "We think a conversion of preferred into common stock followed by a sale within six months is *not* a 'purchase and sale' within the statutory language of §16(b)." And it would have been just as necessary to limit that statement when a case like *Park & Tilford* came along later. No court has divine prescience. Whether there is a conflict between circuits—whether cases are traditionally considered to be distinguishable in the common-law system—depends on actual variations of substance in factual situations, not alone on variations which are expressly taken into account in the first of two opinions. This, we take it, was Mr. Justice Harlan's point in the statement we quoted from his recent Cardozo lecture at the bottom of page 8 of our earlier brief.

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[3]The Commission's brief states (p. 9, n. 13): "The stock was unmarketable only in the sense that it was not traded on an exchange or otherwise actively traded, and that any public offering would have required registration under the Securities Act of 1933 • • •." This is quite an "only."

CONCLUSION

With Petitioner himself conceding that "the Court of Appeals drew the correct rule out of the cases but failed to apply it to the facts of this case" (Pet. for Cert., p. 20), it is difficult to see in the petition more than an attempt to obtain a second appellate review. The need for a second review has not been demonstrated either by Petitioner or by the Commission in its belated entry into the case. The petition should be denied.

Respectfully submitted,

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JAMES A. WEEKS,
Counsel for Respondent

February 18, 1959